

Cautious Optimism

Despite market worries, investors still can find reasons to do deals.

By Jason Mattox

Recently many commercial real estate professionals looking at the state of the market have wondered: Is the glass half full or half empty? The answer to that question often reveals more about the responder's attitude than the reality of how much is in the glass.

In some respects, the same can be said about the commercial real estate market through the remainder of 2008. Both naysayers and optimists can find facts to support their positions. And those wary about the market should take notice that fundamentals appear to be solid; commercial real estate continues to provide cash yields and attractive inflation-hedging characteristics.

Transaction Volume and Net Absorption

Transaction volume predictably has slowed as sellers and tenants await more clarity about the near-term outlook for the credit market and the economy. Through the end of 2007, supply and demand generally seemed to be balanced, rents still exhibited positive growth, and property income was increasing in many markets, according to Prudential Real Estate Investors' January 2008 *U.S. Quarterly Market Perspective*.

As measured by net absorption and new building completions, commercial real estate activity is likely to contract moderately through the third and fourth quarters of this year, according to the National Association of Realtor's 2008 *Commercial Lending Indicator*. Also, commercial real estate professionals can anticipate weaker, though positive, net absorption in the office and industrial sectors later in the year since fewer new buildings are coming on line.

Cap Rates and Property Values

Higher capital costs and slower near-term earnings growth are likely to cause capitalization rates to rise and property values to fall, but not plummet. During the 1Q08, cap rates increased slightly in major markets and therefore have not reflected the current turmoil in the capital markets or the reduced near-term macroeconomic expectations reported by the mass media.

"Property values are likely down," says Dennis Yeskey of Deloitte's real estate capital markets practice. But this is difficult for appraisers to measure with low transaction volume. It also is hard to assess how much of the valuation uncertainty is based on a temporary crisis in investor confidence rather than market realities. Well-located properties with excellent amenities are more likely to maintain their value.

In addition, it may take several quarters for property values to make a noticeable shift. As long as tenant demand doesn't collapse, property values should be fairly stable in the near term. However, risks will be weighted to the downside until the credit squeeze is over and some degree of order is restored to the capital markets.

Fortunately, responsible commercial asset managers have tools at their disposal to support and maintain the property value gains achieved in previous years. Many are finding ways to aggressively manage net operating income, which is driven primarily by the market fundamentals of rent and occupancy, providing relatively positive news. Asset managers also are enhancing value by keeping a lid on expenses, seeking opportunities to buy in bulk and achieve economies of scale, creatively exploiting the competitive advantages provided by their locations and amenities, and pushing for longer lease terms on tenant renewals.

Current Opportunities

Although investor caution is advisable during this period of slow growth, many opportunities still remain available, especially in the hospitality industry. Despite slowing growth in two key industry averages -- the average daily rate and revenue per available room -- hospitality industry profits will rise steadily through 2009, according to PricewaterhouseCoopers' 1Q08 *Real Estate Investor Survey*.

For other sectors such as office and multifamily, potential investors should keep a close eye on local and regional economic forces and employment rates. Aggressive management and strict acquisition criteria will help overcome investor concern, which often is driven by media coverage. However, brokers should be aware about vacancy and cap rates in markets where employment is declining and the potential for growth in rental rates is somewhat limited due to softening demand for space.

Capital Market Forces

The debt capital markets are more discriminating and volatile than in recent years. Loan-to-value ratios are down, and interest-only loans are hard to come by unless the LTV ratio is very low. Buyers requiring high leverage, such as private-equity firms, are out of the game for now unless they can invest more cash or obtain subordinate or mezzanine debt at reasonable rates. Commercial mortgage-backed securities and collateralized debt obligations lenders effectively have been sidelined by rates that remain so high they aren't competitive with other lenders.

But deals are still getting done, and base interest rates have remained low by historical standards. Commercial loans tend to be made at fixed rates, rather than adjustable rates, and refinancing often may not be required for five to 10 years. Owners with long-term, fixed-rate debt are in the best position to ride out the downturn by allowing the income generated by the property to cover their debt obligations until the market rebounds.

The Bottom Line

The commercial real estate industry continues to provide commercial real estate professionals with tax-advantaged opportunities to purchase tangible assets that produce income and generally are considered to be a hedge against inflation. In addition, investors would be wise to remember that when the financial markets become more volatile and riskier, commercial real estate can present a more attractive position relative to traded stocks and bonds, especially for long-term investors. As long as average yield rates for investments remain higher than other investment alternatives, they are likely to continue to be a preferred investment vehicle on a risk-adjusted basis.

The good news is that banks, pension funds, and insurance companies still have funds to lend. Private capital -- both equity and debt -- is available from domestic and foreign sources. Although some may be waiting for market clarity, they continue to exhibit an appetite to invest in commercial real estate. Thus, the advantage will go to disciplined, well-financed buyers with lower leverage requirements, such as non-traded real estate investment trusts. This year may prove to be a good time for value-add and opportunistic real estate investment

funds to acquire properties at attractive prices.

Downturns, like bull markets, eventually end. As long as private equity and debt are still available and market fundamentals remain relatively healthy, commercial real estate assets should remain attractive in most mixed-asset portfolios throughout 2008.

Comparative Returns

Comparative returns as of Dec. 21, 2006 (percent)	1 year	3 years	5 years	10 years
Public REITs (all REITs)	35.06	28.85	23.20	14.48
Private RE (NCREIF-core only)	16.60	17.03	13.27	12.72
Russell 2000	18.37	13.56	11.39	9.44
S&P 500	15.79	10.44	6.19	8.42
DJIA	16.29	6.04	4.46	6.81
NASDAQ	9.52	6.43	4.37	6.46
Lehman govt. bond	3.48	3.20	4.64	5.70

Source: Bloomberg, as cited by Deloitte

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